Understanding Trusts: The 3 'Ts' of Trusts – Terminology, Type, and Taxation

Trusts are an important part of your asset protection and estate plans. Many of you may have assets already in trust or may be considering putting assets in trust. Although trusts carry exotic names like qualified domestic trusts (QDOTs), Walton-style grantor retained annuity trusts (Walton GRATs), and charitable lead annuity trusts (CLATs), at their core, almost all trusts fall into one of the following three categories:

(1) Revocable Living Trusts (RLTs),
(2) Irrevocable Grantor trusts, or
(3) Non-grantor trusts.

By familiarizing yourself with the features of these three types of trusts you'll get a better understanding of how your trust works (or doesn't work).

Mastering Trust Terminology: Grantor, Trustee, & Beneficiaries

The person who creates a trust, and usually contributes the initial assets is known as the *Grantor* (also called the Settlor or the Trustor). The Grantor transfers legal title of property placed in trust from her or himself to the Trustee.

Once assets are transferred to the trust, the *Trustee* has a fiduciary duty to manage the trust property in good faith, for the benefit of the trust beneficiaries. The Grantor is typically the initial Trustee.

Beneficiaries are the individuals whom benefit from the trust. They are eligible to receive distributions from the trust. *Income Beneficiaries* have the right to receive income from a trust. *Remainder Beneficiaries* have the right to receive the principal (also called the corpus) of a trust only after the expiration of the Income Beneficiary's interest.

Revocable Living Trusts (RLTs)

RLTs are not asset protection devices. All assets in the RLT are fully accessible by the Grantor and thus, are also accessible by the Grantor's creditors because the Grantor retains the power to revoke, amend and modify the trust, and retains broad powers over the trust assets during her/his lifetime.

A Grantor re-titles assets in the name of the RLT to avoid probate – the process of going to court to prove a will to be valid and to oversee the distribution of assets. The RLT, therefore, is intended as a cost saving device – to avoid probate and thereby minimize court costs and legal fees after the Grantor's death. Since the process of probate is a public court process, the RLT also helps to provide for family privacy which may be very important to wealthy families or individuals with celebrity or public status.

For uncomplicated estates or states that have a rather straightforward, inexpensive, and quick probate process, RLTs are not an indispensable part of an estate plan. But RLTs are especially helpful in dealing with out-of-state real property. By re-titling out-of-state property in the name of the RLT, a probate proceeding in the other state ("ancillary probate") can be avoided.

RLTs can also help if the Grantor becomes incapacitated and can no longer manage her/his assets. Provisions in the RLT may provide that a Successor Trustee will take charge of the RLT's assets, therefore providing continuity of asset management. This is ideal for those with commercial property or closely held businesses.

Any income generated by assets in the RLT will be taxed to the Grantor.

Irrevocable Grantor Trusts

By definition, a grantor trust is a trust that reserves in the Grantor a certain power found in the Internal Revenue Code (IRC) §§ 671-679. The power to revoke a trust is found in § 676, therefore an RLT is technically a grantor trust.

However, this section will only address *irrevocable* grantor trusts - irrevocable meaning that the Grantor *cannot* revoke, amend or modify the trust during her/his life, but has retained some other power within §§ 671-679 to have the trust qualify as a grantor trust.

When a Grantor transfers assets to an irrevocable trust, the transfer is typically treated as a completed gift for gift and estate tax purposes. This transfer removes assets from the Grantor’s estate and done correctly, by leveraging certain gift and estate tax exemptions allowed by law, may be done potentially free from gift and estate taxes. However, by qualifying the trust as a grantor trust, you, as the Grantor, will be treated as the owner of the trust *for income tax purposes.* That means all trust income will flow to you for income tax purposes only. That is usually a good thing. By transferring assets to the irrevocable trust, you are reducing the size of your estate for estate tax purposes. By paying the income tax on the income generated by the assets in the trust, you are further reducing your estate and are also allowing the trust assets to grow undiminished by taxes.

These trusts are also known as “intentionally defective grantor trusts” (IDGTs), although there is nothing defective about them. Although the Grantor is treated as the owner of the trust for income tax purposes, the Grantor is *not treated as the owner of the trust for estate and gift tax purposes!* That means that any assets in the IDGT will *not* be included in the Grantor’s taxable estate. This result is due to the nuances in the tax system and the fact that the income, gift and estate tax systems are not fully integrated.

Finally, drafted correctly - without outright distributions to trust beneficiaries and providing broad discretion to disinterested trustees to make distributions to beneficiaries - the creditors of the beneficiaries cannot reach the assets that you put into the IDGT. In most situations, depending upon trust provisions, when the trust was funded, and the state in which the trust was created, even your creditors may not be able to reach these assets.

Non-Grantor Trusts

A non-grantor trust is, by definition, not a grantor trust. This means that the grantor does not reserve one of the powers listed in IRC §§ 671-679, and therefore, the trust is not revocable.

In a non-grantor trust, the grantor is *not* treated as the owner of the trust assets for income tax purposes. Income generated by a non-grantor trust is either taxed to the trust or to a trust beneficiary.

For example, if the non-grantor trust generates $15,000 of taxable income and distributes it to a beneficiary, assuming the beneficiary is in a 25% tax bracket, she/he will have to pay $3,750 in income tax.

If the trust did not distribute the $15,000 to the beneficiary, but instead retained it in the trust, the trust would have to pay income tax on it at the trust’s tax rate (reaching 39.6%) (see table), resulting in $4,269.10 of tax.

Trust’s Taxable Income	Trust Tax Rate
Not over $2,500	15%
Over $2,500, not over $5,800	$375 + 25% excess over $2,500
Over $5,800, not over $8,900	$1,200 + 28% excess over $5,800
Over $8,900, not over $12,150	$2,068 + 33% excess over $8,900
Over $12,150	$3,140.50 + 39.6% excess over $12,150

The example above is overly simplistic because it neglects several technical aspects of trust taxation such as the concept of "distributable net income," however it does accurately express who is liable for the tax – and the relevant tax rates – when dealing with non-grantor trusts.

You can also see that a trust reaches the top income tax bracket at a fairly low level of taxable income so generally, it would be desirable for trusts that hold significant income producing assets to distribute trust income to beneficiaries who may be in lower income tax brackets.

Finally, assets placed in a non-grantor trust will generally not be included in the Grantor's estate, and may be protected from the Grantor's (and other trust beneficiaries') creditors if done correctly.

The Three "Ts" of Trusts: In Summary

RLTs are not asset protection devices, they are probate avoidance devices and may also provide some asset management benefits during the life of the Grantor. IDGTs are excellent estate planning and creditor protection devices where the income generated by trust assets is taxed to the Grantor. Non-grantor trusts are also excellent estate planning and creditor protection devices, however the income generated by the trust assets is taxed either to the trust or to the trust beneficiaries, depending on whether the Trustee distributes the income or accumulates it within the trust.

Make sure you receive a thorough explanation of the trust terms of your trust and how your trust operates from your attorney. Choosing the right kind of trust is vitally important for asset protection and estate planning purposes.

Type of Trust	Income Taxed To	Included in Taxable Estate	Avoids Probate	Creditor Protection
Revocable Living Trust	Grantor	Yes	Yes	No
Grantor Trust (Irrevocable)	Grantor	No	Yes	Yes
Non-Grantor Trust (Irrevocable)	Trustee or Beneficiary	No	Yes	Yes

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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